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Weekly Market Update

Treasuries rally, equities give back gains as Ukraine fears dominate

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Article Highlights

- Escalating tensions in Ukraine overshadow generally strong U.S. earnings reports.
- Treasuries benefit from increased demand for safe-haven assets.
- Housing market indicators continue to disappoint, but industrial activity improves.
- European and Japanese central banks face similar pressure to provide more stimulus.
- Overall, the backdrop for U.S. equities remains favorable.

April 25, 2014

Equities

Favorable first-quarter earnings releases during the past week helped the S&P 500 Index get off to a solid start. However, as the week drew to a close and tensions in Ukraine intensified, U.S. equities erased their earlier gains. European equities also fell on Friday, erasing more than half of their previous four-day advance. Chinese stocks moved lower throughout the week amid more evidence of China's slowing economy. Other emerging equity markets followed suit.

Fixed income

U.S. fixed-income markets realized modestly positive returns during the week. Investment-grade corporate bonds and mortgage-backed securities were among the better performers through April 24, based on Barclays indexes. U.S. Treasury prices rose, and their yields fell, benefiting from weaker U.S. housing data and increased demand for safer assets amid a continuing escalation of tensions in Ukraine. The closing yield on the 10-year Treasury dipped from 2.73% at the beginning of the week to 2.65% in midday trading on April 25. Overall, fund flows continued to support nearly all fixed-income asset categories.

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Financial Services

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Mixed U.S. economic data: weaker housing, stronger durable goods

Data released during the week underscored both patches of weakness and areas of improvement in the U.S. economy.

Housing market indicators continued to soften, and it appears increasingly likely this will be a slow spring for housing across the country.

- **Existing home sales** fell 0.2% in March to their lowest level in nearly two years, although results were somewhat better than downbeat forecasts.
- **New home sales** tumbled 14.5% in March, reaching their lowest level since last July.
- **Mortgage applications** declined 3.3% in the most recent week and were nearly 60% lower than a year ago, according to the Mortgage Bankers Association.

Industrial activity continued to pick up in March, evidenced by a number of key measures:

- Orders for **durable goods** (big-ticket items such as heavy machinery, aircraft, and computer equipment) climbed 2.6% in March—ahead of most forecasts and the best result since last November.
- The **Richmond Fed index** of regional manufacturing, which covers activity in Washington, DC, Virginia, Maryland, North Carolina, South Carolina, and most of West Virginia, jumped in April, with gains in shipments, new orders, and hiring.
- Although the “flash” (preliminary) Markit **Purchasing Managers Index (PMI)** edged slightly lower in April, to 55.4, it remained well above the 50 threshold indicating expansion, with improvements in new orders, exports, and production.

Other positive data released during the week included:

- The Conference Board’s index of **leading economic indicators (LEI)** rose 0.8% in March, after a 0.5% gain in February. Because first-time unemployment claims, one of the components of the index, came in higher than expected in the most recent week, we expect next month’s LEI reading to soften.
- **Consumer sentiment,** as measured by the Thomson-Reuters/University of Michigan index, climbed from 80 in March to 84.1 in April—exceeding forecasts and reaching its highest level since July 2013.

In Europe, growth signals are positive but the need for monetary stimulus remains

European economic readings and corporate earnings releases have been encouraging. April's Markit PMI for the eurozone rose to 53.3, led by Germany. We remain somewhat cautious, however, because Europe's favorable picture may be temporarily skewed by a mild winter. If so, we could see a loss of momentum going forward. Financial markets seem less concerned about this prospect, as investors expect the European Central Bank (ECB) to pursue further monetary stimulus under any scenario, given the potential for harmful deflation. We believe the ECB is gearing up for a further interest-rate cut, followed by additional stimulative measures later in the year.

Japanese inflation remains too low to achieve growth objectives

The jury is still out as to whether Japan's monetary policies are working effectively to boost inflation, but in our view the most recent data is not promising. The March headline figure came in at 1.6% year-over-year. However, the core measure that removes volatile energy and food prices—a better guide to future inflation movements—was up only 0.7%. We believe this will push the Bank of Japan one step closer to enacting further stimulus measures.

China's slowing economy may begin to improve

Chinese economic releases were again less than stellar. At 48.3, the flash PMI published by HSBC stayed below 50 in April, although the slight uptick (+0.3) marked the first increase in six months. While the risk of further slowing and a potential "hard" economic landing in China is real, the modest improvement in PMI may be one sign that stimulus measures are beginning to have a positive impact. In addition, if the government can stave off a collapse in real estate prices, this sector of the economy could offset sharply lower investment spending. Elsewhere in the emerging markets, economic expectations remain broadly weak, although conditions vary widely among individual countries.

Outlook

It now appears that March was the strongest month of the first quarter and may have provided some momentum heading into the second. On balance, the economy is moving in the right direction following the winter slowdown.

Overall, the backdrop for U.S. equities is favorable. First-quarter earnings results have been better than expected, interest rates remain low, and in our view, valuations are not stretched. An increase in mergers and acquisitions activity is also supporting the market, as low rates, improving confidence, and abundant cash levels are driving U.S. corporations to deploy capital.

In fixed-income markets, rising interest rates are still a risk, given the gradual strengthening of the U.S. economy. We expect market volatility to increase as the year progresses and Fed tapering winds down. The recent outperformance of emerging-market debt is likely to fade, while investment-grade corporate bonds appear poised to rally further.